# Asset Reallocations During Turbulent Times

## Key Issues to Consider When Planning a Portfolio Transition

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Manager changes and asset reallocations present myriad risks to the institutional asset owner and are often the most impactful drivers of a fund's trading costs. In these uncertain, turbulent times with global markets prone to unprecedented movement, the stakes are amplified. As such, asset allocators who are approaching portfolio changes should consider strategic planning and fiduciary caution as paramount. Given Abel Noser's unique perspective as practitioners of both Trade Cost Analysis (TCA) and agency-only transition management, we are offering here a number of best practices to help you mitigate risk and lower transaction costs on your upcoming asset reallocations.

**Moving Day**

A recent study noted that, on average, Americans change residences twelve times in their lifetime. While nobody enjoys moving, it is an unpleasant reality that we are all accustomed to. Many of the considerations and challenges that go into a home move are also analogous to asset owners who face fund reallocations. For example:

- **Timing** –What are my start-to-finish timeline requirements?
- **Methods** – Do I go DIY ("do it yourself"), or do I need to hire professional movers?
- **Costs** – What are the explicit costs? What are the less obvious costs?
- **Risks** – Operationally, how do I ensure my assets are moved safely to their new home?
- **Obstacles** – Are there potential pitfalls that I may be missing?

Although conceptually similar, the scale of what constitutes a positive or negative outcome is exponentially larger when we're talking about transitioning portfolios. Without a concerted strategy, asset owners may be exposed to undue risks that can have catastrophic consequences. The case study described below (which Abel Noser was asked to review after the fact), unfortunately illustrates how an asset move can sometimes go drastically wrong.

**Case Study – Loss of $39 Million**

Last year, Abel Noser helped an asset owner conduct a detailed post mortem on an event they undertook on their own – without the aid of a transition manager. They gave directions to the

legacy managers and the target managers and attempted to align their actions in such a way as to minimize transaction costs and market risk. However, they had not conducted such an undertaking on their own before and this inexperience led to several otherwise avoidable errors.

In particular, certain expectations were not clearly communicated, and unintended market risks were introduced - that careful planning and coordination would have mitigated. The result was a loss of $39 million in asset value.

## Portfolio Transition 'Moving' Day

Without adequate planning, portfolio transitions can easily go awry

**Recent Case Study:**

An asset owner undertook a plan-led event in Q2 of last year.

- Legacy and target managers were allowed to trade their own portions of the event.
- Expectations regarding pace of trading were not clearly established.
- The plan was under-exposed to the market for an extended period of time.
- **The result: a loss of $39 million**

***How can this experience be avoided on future transitions?***

In terms of our analogy, this would be like if you decided to move yourself but could not quite figure out the latch on the back of your truck, resulting in all your things ending up on the highway!

To be clear, most portfolio reallocations are made with the belief that the target allocation will add alpha over the existing portfolio lineup. The actual implementation of that change, though, can erode some of this alpha. In this regard, a lack of thorough planning may often add costs and increase risk. And no surprise, such risks are only exacerbated in times of elevated market volatility.

With such cautionary outcomes always on our mind, a considerable portion of Abel Noser's transition management department's time and resources are spent identifying risks and crafting solutions that help clients avoid such situations. When market volatility spikes, as we have seen this year, this becomes an even more crucial element of our pre-planning process.

**2020 Volatility**

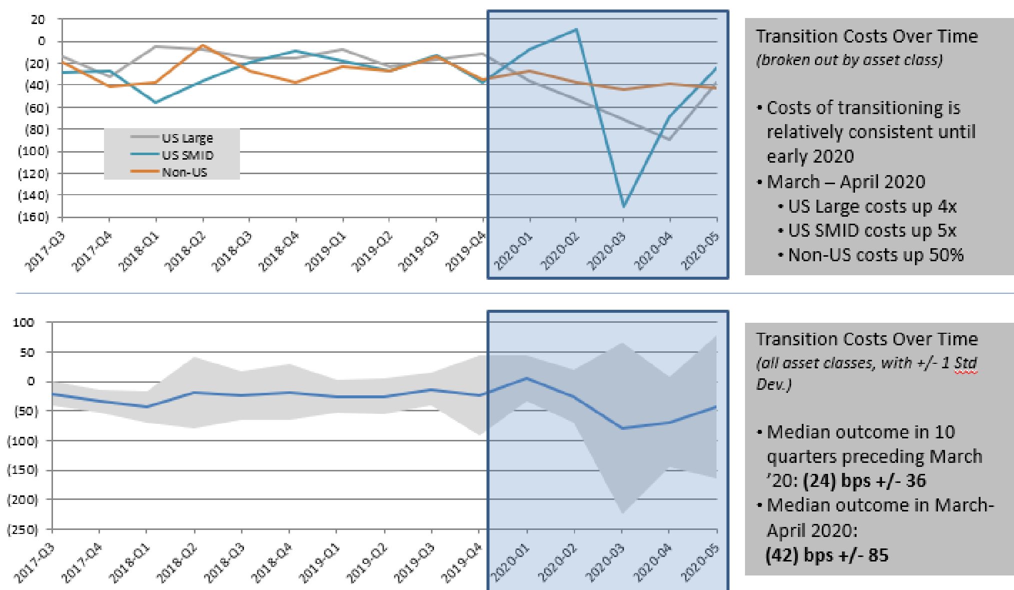
A hallmark of prudent pre-trade planning is helping clients understand the potential loss to asset value in getting from point A to point B. No small part of that is factoring in trading costs. This required even more nuance this spring, when markets reacted to the fallout from the pandemic and the VIX went from 18 to 80. How did that affect the range of outcomes for asset owners?

As a fintech firm that focuses on TCA and compliance surveillance, Abel Noser Solutions has been measuring transaction cost data since the mid-1980s. Today, ANS measures about $16 trillion in principal traded across several asset classes. Our company's research committee recently performed the below study in which we queried our universe of measured trades and pulled out nearly 3,000 transition/reallocation events over the past three years, involving roughly $440 billion in principal traded.

The below charts detail some of the key findings of that analysis, with particular focus on the first few months of 2020. As you can see, we found some interesting results.

## Reallocation Outcomes in 2020

ANS Event Universe - 2,932 reallocation events, totaling $440 billion




In March and April 2020, the cost to implement reallocations in US Large Cap equities went up four times the historical norm established by the preceding 10 quarters! US Small and Mid Cap costs during this time increased five times. The uptick in non-US equity costs was less pronounced but certainly notable at plus 50%.

More importantly, we saw fatter tails. The lower part of the chart shows the median outcome for global equities reallocations along with a plus or minus of one standard deviation in a range of outcomes. We revealed not just an uptick in the median outcome, but a widening of the range from +/-36 basis points to +/-85 basis points.

This is not to say that an asset owner should not reallocate assets when markets are volatile. Rather, it underscores the necessity for a transition management partner who understands your goals and can develop a strategy that is able to navigate ever-evolving market conditions.

In addition to market volatility, an equally important pre-trade consideration is deciding who to use for implementing the move.

**How Do Asset Owners Approach Reallocations?**

The table below identifies various alternatives for completing an allocation change. The first three columns are iterations of a DIY move and, in most cases, expose the plan to various degrees of undue risk. The shaded column on the right corresponds to using an effective transition manager ("TM').

## Analysis of Transition Alternatives

**Options for Completing an Allocation Change**

| Key Questions | Liquidate & Transfer Cash | Target Manager Execution | Plan-Coordinated Event | Transition Manager |
|---|---|---|---|---|
| Is investment exposure maintained? | No | Possibly | Difficult | **Yes** |
| Who shoulders the operational burden? | Trustees / Administrators | Trustees / Administrators & Target Manager | Trustees / Administrators | **Transition Manager** |
| Who has fiduciary responsibility? | Board? | Target Manager? Board? | Board? | **Transition Manager** |
| Is specialized transition reporting available? | No | ? | ? | **Yes** |
| Is there performance accountability throughout the process? | No - cash drag | No - legacy intertwined, necessitating performance holiday | ? | **Yes** |

Ultimately, only the asset owner can decide which route best meets its needs. However, asset owners should understand the risks associated with each respective option so they can prudently balance those risks against whatever other considerations they may have.

The most problematic route an asset owner can pursue is permitting a legacy manager to liquidate the portfolio to cash. In addition to the fund being underexposed to the benchmark between the trades settling and the new manager reinvesting the funds (and thereby at the mercy of an unpredictable market), the fund loses the benefit of in-kind transfers between the legacy and target mandates. In other words, a fund can find itself selling a position only to buy it back a few days later at a potentially disadvantageous price.

Further, from a TCA perspective, these trades are typically the costliest. We all too often observe terminated managers paying full-service commission rates (often to catch up on soft-dollar research bills). And with interests no longer aligned with the asset owner, a commitment to best execution can sometimes be lacking.

Letting a new manager assume the legacy holdings, to manage out, is a marginally better alternative. However, while the target manager is certainly more inclined to keep costs low and do right by their new client, what they deem to be a competitive execution-only commission rate is largely subjective. Further, not all target managers are adept at executing portfolio trades, and/or are unfamiliar with the legacy securities. Consequently, utilizing the new manager to implement a transition often creates a situation ripe for that manager requesting a "performance holiday." This can result either in reporting headaches and/or a period in which the trustees themselves "own" the performance of the portfolio.

For these reasons and more, utilizing a dedicated TM has been widely accepted as a best practice for decades. A high performing TM brings project management expertise to bear and coordinates the event from start to finish. As a result, the asset owner maintains market exposure, takes advantage of in-kind positions between the legacy and target portfolios, and benefits from a dollar-neutral trade that mitigates market risk. A good TM can also provide enhanced accountability and transparency with specialized pre and post-trade reporting.

However, not all TM's are alike…

**Different TM Models with Different Results**

A transition manager's business model brings various strengths and potential blind spots to their respective platform. Asset owners are faced with the challenge of simultaneously aligning the model best suited to the demands of a given project while identifying conflicts they may not be comfortable with as fiduciaries. The chart below outlines integral elements, the positive and the negative, of five basic TM models:

## Different TM Models Bring Different Strengths & Risks

### Transition Management is Not a Commodity

| Transition Capabilities/Risks | Agency-Only | Investment Banks | Custodians | Legacy Managers | Target Managers |
|---|---|---|---|---|---|
| Best Ex/Access to Liquidity | ✓ | ✓ | ✓ | ⚠ | ⚠ |
| Operational Expertise | ✓ | ✓ | ✓ | ⚠ | ⚠ |
| Specialized Reporting to Ensure Transparency | ✓ | ✓ | ✓ | ⚠ | ⚠ |
| No Proprietary Trading | ✓ | ⚠ | ✓ | ✓ | ✓ |
| Affiliated Index Funds | | | ⚠ | | ⚠ |
| Ability to Commit Capital | | ⚠ | | | |
| Soft-dollar Credits | | | | STOP | STOP |
| In-kind Transfers | ✓ | ✓ | ✓ | STOP | STOP |

When a transition manager's interests are not fully aligned with the asset owner, a perceived strength can, in fact, introduce considerable risk not immediately apparent on the surface. For example, the ability of an investment bank to commit capital for a principal trade, essentially buying the downside risk, can certainly be a benefit that other providers are not able to facilitate. However, since in these instances the investment bank is "taking the other side" (i.e. their profit is a function of the price they buy/sell those securities for), it is critical that the asset owner has a clear understanding of what a reasonable "haircut" should be for the investment bank assuming the aforementioned risk.

Similarly, transition managers with affiliated index funds may emphasize the savings yielded from their "crossing" practices. In other words, instead of trading a position in the open market, they try to find the other side from their affiliated index fund. When they do, the asset owner's security is "crossed" with the index fund, often at no commission to the asset owner (and sometimes less market impact cost). Of course, any explicit savings for the asset owner is beneficial, but commissions represent just one piece of the pie.

Trading is a zero sum game and waiting to cross with an affiliated index fund often entails delaying the execution of a trade until later in the day or week (i.e. when the affiliate index fund is able to cross). In fact, in many instances, our Trade Cost Analysis suggests that such delays result in opportunity costs (and sometimes adverse selection) that would otherwise have been avoided by trading earlier. For this reason, as with TMs who commit capital, asset owners need to fully understand not just the potential benefits, but also the potential risks and tradeoffs associated with this approach.

From our perspective as practitioners of both TCA and TM, in most instances, the pure agency model provides asset owners with all the virtues necessary for an optimized transition without the conflicts of interests and hidden revenue streams inherent in other models. Transition managers acting as agent do not manage money or trade for their own account and, as such, find their interests naturally aligned with those of their clients. Their compensation is transparent and explicitly negotiated well before the transition actually begins.

Successful transitions are largely of function of planning and coordinating the many operational steps leading up to and after "moving day." And ultimately, the culmination of every transition is a trading exercise. In this regard, prudent transition management should utilize TCA to inform every stage of its process – developing a strategy/timeline, communicating expected costs, vetting execution venues, identifying liquidity pockets and reporting on actual costs incurred after the trade.

**Conclusion**

Not everyone who needs to move uses a mover. However, the more assets you accumulate, the more important it is to use a professional moving company. Similarly, not everyone will hire a transition manager. But if you decide using a transition manager makes sense, where does one begin?

At Abel Noser, we encourage clients to look for a strategic partner who will stand ready to serve as an extension of their staff when the need arises. You should also identify any potential conflicts of interest (i.e. hidden revenue streams, proprietary trading, etc.) and ensure your chosen transition manager's goals are aligned with those of your fund. As a result, you should expect and demand a transparent process as well as a partner acting as fiduciary.

**Key Takeaways**

- As fiduciaries, asset owners are not expected to have a crystal ball. Rather, the metric for evaluating prudence is *process and planning*.
- The hallmark of a successful transition is defined by the ability to manage risks and preserve asset value.
- The TM should act as the quarterback who makes sure everyone (client, traders, custodians, and managers) is up to date with the process. The TM should also make sure all parties know what's expected of them, and when it's expected.
- Engage a partner with aligned interests. They should be highly communicative, providing a bridge of transparency that connects all parties involved.
- When reallocating assets during uncertain times, it's crucial to understand the many potential risks and engage a TM partner who can help plan accordingly to minimize costs while improving outcomes.
- The golden rule, in both asset allocations and in moving, is that **planning pays off**.

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